Falling short

The case for abolishing the standard interest rate used to calculate support for mortgage interest

February 2012

Contents

Summary

The support for mortgage interest (SMI) scheme aims to help homeowners in receipt of one of four means-tested benefits to stay in their home by providing payments to cover their monthly mortgage interest and provides a crucial safety net for the poorest home owners. To calculate the amount of help due under the SMI scheme, a standard interest rate is used rather than the actual interest rate charged on each mortgage. This is to make the scheme administratively simple and reduce overpayment.

This report uses CAB evidence to argue that the use of a standard interest rate to calculate the amount of SMI claimants receive each month is ineffective, inequitable and causes hardship to claimants. The evidence set out in the report demonstrates that the Government's decision to reduce the standard interest rate from 6.08 per cent to 3.63 per cent in October 2010 has had caused significant detriment to claimants. Analysis of CAB evidence on SMI since October 2010 shows that:

- CAB clients experienced an average shortfall between the amount of SMI received and their contractual mortgage interest payment of £135 per month.
- Contrary to Government expectations mortgage lenders have not absorbed this shortfall; 33 per cent of CAB clients seeking advice on this issue reported that their lender had initiated possession action, or were threatening to do so, following the change.
- The reduced level of support available to claimants has had a significant detrimental impact on claimants; in 29 per cent of the cases analysed, the client concerned reported that the reduction in their monthly SMI payments had had an impact on their mental health.

While the current system for calculating the amount of support available to claimants is administratively simple, we are concerned that it has failed to adequately meet the needs of claimants and does not provide value for money. We recommend that the Government introduces a system whereby SMI is paid at the actual contractual interest rate of each claimant. We also set out our proposal for a more cost effective way of administering SMI claims.

Introduction

When personal circumstances change, perhaps through loss of employment, sickness or relationship breakdown, homeowners can find themselves unable to continue to meet their monthly mortgage payments and in need of financial assistance. The SMI scheme aims to help these people to stay in their homes by providing payments to cover the mortgage interest of those in receipt of one of four means-tested benefits.[1] SMI was claimed by 247,000 people in 2010 and provides a crucial safety net for the poorest home owners.[2] It can make the difference between a family being able to stay in their home and get back on their feet or becoming homeless.

This report focuses on the impact on CAB clients of the Government's decision to change the way in which the standard interest rate, on which the level of SMI payable to borrowers is based, is calculated in October 2010. It argues that using a standard interest rate to calculate SMI creates a shortfall in support for many claimants, causing hardship and inequity between claimants. It also argues that this decision has made arrears problems worse, threatening the homes of some SMI claimants, and has hit some of the most vulnerable in society very hard.

SMI has been a key part of the Government's strategy to prevent homelessness and has become increasingly important in the context of a turbulent economic climate. The financial crisis in 2008 and subsequent recession caused unemployment to soar. This exacerbated problems with mortgage arrears and possessions that the CAB service was already seeing; partly as a result of poor lending and arrears management practices in the sub-prime mortgage market in particular. Mortgage possessions rose from 25,900 in 2007 to 40,000 in 2008 and 47,900 in 2009.[3]

The financial climate remains unstable and in the context of the Government's focus on deficit reduction, wide ranging cuts to public expenditure and the continued rise in unemployment, demand for advice on mortgage debt is still high. The CAB service received 103,487 enquiries about this issue in 2010/11. Of these, 11,234 enquiries were about possession claims for mortgage arrears and 3,800 enquiries were about eviction due to arrears. Bureaux also dealt with 13,100 enquiries about SMI in that period. In this context it is hardly surprising that the Government's decision to reduce the amount of support available through SMI in October 2010 has had a hugely detrimental impact on claimants.

Prior to October 1995 the level of SMI payable each month was calculated using the claimant's actual interest rate. The Government found that this system, which relied on claimants reporting changes in their contractual interest rates, added administrative complexity and increased the likelihood of errors, overpayments and increased costs. Consequently, since October 1995 claimants' monthly SMI payment has been calculated using a standard interest rate. Under this system the percentage of the eligible capital paid to claimants is the same irrespective of the contractual interest rate attached to the claimant's mortgage.

> For example: if the standard interest rate used to calculate SMI were set at two per cent, all claimants with a £200,000 mortgage would receive £333 per month towards their housing costs. Therefore, a claimant with an interest only mortgage and an interest rate of 3.2 per cent would have a contractual monthly interest payment of £533 but would receive the same level of support, £333 per month, as a claimant with an interest rate of 1.3 per cent and a contractual monthly interest payment of £217.

The way that the standard interest rate is calculated has been through a number of changes since this time. From November 2004 the standard interest rate was calculated by reference to the Bank of England base rate plus an additional 1.58 per cent. However, in the autumn of 2008 the Bank of England base reduced quickly, hitting 0.5 per cent in March

1. Recipients of income support, income-based job seeker's allowance, income-related employment and support allowance or pension credit may also be eligible for SMI.
2. Department for Work and Pensions (December 2011). *Support for Mortgage Interest: Informal call for evidence*. Annexe B, Table 2.
3. Ministry of Justice Statistical Tables *Mortgage Possession Actions in the county courts of England and Wales 1990-2011* Q3 http://www.justice.gov.uk/downloads/publications/statistics-and-data/mojstats/mortgage-landlord-possession-stats-tables-q3-2011.xls (Table 1).

2009. But interest rates in the mortgage market did not fall as fast, creating a gap that would have seriously eroded help from the SMI scheme. In the context of an uncertain economic outlook, growing unemployment and a 12 per cent rise in repossessions from the second to the third quarter of 2008, the decision was taken to freeze the standard interest rate at 6.08 per cent.[4]

Under the frozen standard interest rate some 92 per cent of home owners received SMI payments in excess of their actual monthly mortgage interest payments, which helped some claimants to deal with arrears including suspending possession action in the courts[5]. But other borrowers were able to use the excess payment to pay down capital and the Government felt this was not making best use of taxpayers' money, particularly given the budget deficit, and that the existing arrangement could no longer be justified.

As a result the standard interest rate was changed again in October 2010 to reflect an average of actual mortgage rates published by the Bank of England. This meant an immediate reduction to a new rate of 3.63 per cent for all SMI claimants no matter what their actual mortgage rate was.[6]

Given the highly differential mortgage market, Citizens Advice would question whether a standard interest rate, particularly one based on a unitary average interest rate, will ever be an effective or fair way of calculating the level of SMI claimants should receive. The interest rates attached to mortgages vary widely across products and by definition a large proportion of SMI claimants will be paying above the market average. For instance, market rates published by the Bank of England show a dispersion of two year fixed-rate deals between 3.2 per cent for 75 per cent loan to value and 5.45 per cent on 90 per cent loan to value.[7]

An impact assessment by the DWP estimated that a significant number of borrowers eligible for help with mortgage interest would face a shortfall between help from SMI and the actual interest payment required by their lender.

The DWP forecasted that if the standard interest rate was set at 3.63 per cent then 50 per cent of claimants would not have their eligible housing costs fully met by their benefit award; 48 per cent would have less than 90 per cent of their housing costs met and 7 per cent would have less than 60 per cent of their monthly payment covered by SMI.[8]

Based on 247,000 people claiming SMI in 2010/11,[9] we estimate that 118,560 SMI claimants would have less than 90 per cent of their housing costs met and 17,290 claimants would have less than 60 per cent of their housing costs met.

Lord Freud, the Minister for Welfare, announced that when the change was introduced the Government expected mortgage providers to soften the impact of the changes by averaging out the rates charged to borrowers to reflect the fact that SMI payments are guaranteed payments from the Government, and therefore come with a "triple-A-rating". He also stated that the Government would consider legislating if a voluntary agreement was not reached.[10]

But CAB evidence in this report shows that this has not been the case for many borrowers. Mortgage lenders have not necessarily absorbed the difference or shown forbearance to borrowers unable to make up the shortfall in SMI support from the part of their means-tested benefit meant for food, heating and other living costs. This has resulted in low income home owners having to choose between hardship and mortgage arrears.

The DWP is currently consulting more generally on the future of SMI, including the standard interest rate. Citizens Advice has significant concerns about some of the suggested policy changes, including:

- Putting a charge on the property of SMI claimants after two years as a condition of ongoing support.
- Extending the unfair two year limit on help

4. Department for Work and Pensions (November 2008). *Support for Mortgage Interest Changes – Equality Impact Assessment*.
5. Department for Work and Pensions (November 2008). *Support for Mortgage Interest Changes – Equality Impact Assessment*.
6. Department for Work and Pensions (December 2011). *Support for Mortgage Interest: Informal call for evidence*. p25.
7. Bank of England (January 2012). *Trends in Lending*. Loan pricing Table 2.5 http://www.bankofengland.co.uk/publications/other/monetary/LoanPricingJanuary2012.xls
8. Department for Work and Pensions (August 2010). *Equality Impact Assessment Support for Mortgage Interest*.
9. Department for Work and Pensions (December 2011). *Support for Mortgage Interest: Informal call for evidence*. Annexe B, Table 2.
10. Financial Times online edition. (Published 30 September 2010). *Lenders shun mortgage plan for jobless*.

with housing costs to a larger number of home owners in receipt of jobseeker's allowance (JSA).

- Ending payment of SMI directly to lenders. We are concerned that mortgage providers may be less willing to forbear in cases where SMI is in payment if payments are no longer made directly to the lender, and are therefore no longer guaranteed. The Council of Mortgage Lenders (CML) share our concerns about this proposal due to the risk that 'some of the funds designed to help meet mortgage costs will be diverted to other spending by some claimants'.[11]

We will outline these concerns in full in our response to the consultation paper.

Methodology

The report is based on 456 bureaux evidence forms (BEFs) submitted by bureaux between October 2010 and October 2011. BEFs are anonymous case studies which highlight particular problems that cannot be solved by advice and support alone and their impact on CAB clients. BEFs are not submitted for every enquiry and so do not give us hard numbers on the sort of problems CAB clients are experiencing. But they do allow us to identify broad trends in key practices and products causing consumer detriment. The number of BEFs we received represents three per cent of all enquiries about SMI in this period.

Why the standard interest rate is not working

Citizens Advice believes that there are four main problems associated with using a standard interest rate to calculate SMI payments:

- The shortfall in SMI support for many claimants creates hardship.
- The standard interest rate creates inequity between claimants as some people have all of their mortgage interest paid and others experience a shortfall.
- It is making arrears problems worse and threatening the homes of some SMI claimants.
- Some of the most vulnerable in society are being hit very hard.

Using a standard interest rate creates a shortfall

Of the 456 BEFs submitted about CAB clients describing the impact of the standard interest rate change between October 2010 and October 2011, 214 contained information on the shortfall between the amount of SMI received by the client each month and their contractual monthly interest payment. The average shortfall experienced by these clients following the change to the standard interest rate was £135. As noted above, SMI is only available to those already in receipt of particular benefits. By definition, therefore, recipients of SMI will be reliant on benefits as their sole, or main, source of income. As a result, having to find, on average, an extra £135 per month on a low income and often already stretched budget, has inevitably caused a considerable amount of hardship and detriment to those in receipt of SMI.

It is perhaps not surprising then that our evidence would appear to support the early findings of research conducted by the University of Glasgow in the three months following the change to the standard interest rate. This research found that mortgage providers were not approaching the change as positively as the Government may have wished. The mortgage providers interviewed stated that, while it was too early to assess the full impact of the changes, early indications showed an ongoing build up of short falls in payments and, therefore, arrears. One building society reported that prior to the rate reduction, 25 per cent of borrowers in receipt of SMI (who made up one per

11. Council of Mortgage Lenders press release (6 December 2011). http://www.cml.org.uk/cml/media/press/3112

cent of its total borrowers) were in arrears, but that this had increased to 46 per cent after the change.[12] The research also found that mortgage providers were increasingly questioning the desirability and feasibility of continuing to forebear, particularly in cases where SMI did not meet the borrowers' monthly costs in full.[13]

Of the 448 case studies regarding the reduction in SMI:

- Sixty nine per cent stated that the change in the amount of support they received had caused or exacerbated financial difficulty.
- Fourteen per cent stated that the client had not been in arrears before the change but felt that they were likely to fall into arrears following the change.
- Forty three per cent said that the client felt that they were at risk of losing their home and four per cent of the clients had taken the decision to sell their home.

The following case studies provide some examples of the impact on claimants of a shortfall:

> A CAB in the South East reported the case of a 68 year old man who was retired and living on his own in a leasehold flat. His only income came from benefits, including pension credit. As a result of the reduction in the standard interest rate used to calculate SMI, his income had been reduced by £87 per month. His mortgage provider had not reduced his mortgage rate to match the SMI reduction and the client, already £1,700 in arrears, could not afford to make up the shortfall from his limited income. The client was already stressed because of his health problems and the difficulty of keeping his head above water. This latest blow had hit him very hard and he felt he could not carry on.

> A CAB in Yorkshire and the Humber reported the case of a couple who were pensioners and reliant on a state pension, pension credit and SMI for their income. They were not informed that the amount of SMI they received each month had reduced, and had therefore unknowingly fallen into arrears. The clients had never been in arrears before and were very distressed. They were now having to make up the shortfall for the mortgage out of their limited income as well as having to pay extra towards the arrears. As a result they were struggling to meet their every-day expenses and maintain repayments to their other creditors. The clients were extremely stressed and had not been able to sleep.

The standard interest rate creates inequity between claimants

Using a standard interest rate based on market averages inevitably produces an inequitable situation whereby a number of people are overpaid, and therefore may benefit, while others will be underpaid and therefore will be disadvantaged, and in some cases significantly so.

As noted above, the mortgage market is diverse with a wide range of products and interest rates on offer. The interest rate attached to a mortgage product will vary depending on the percentage of the loan compared to the value of the home, the type of mortgage and the mortgage provider. For example, a Citizens Advice research report entitled *Turning the tide?*, which analysed evidence on mortgage and secured loan possession actions in England in July 2009, found that clients with sub-prime mortgages were on average paying significantly higher interest rates than those borrowing from high street lenders.[14]

Basing SMI payments on a standard interest rate set at the market average therefore creates a situation whereby those with above average interest rates, who are already paying more for their mortgage, are penalised again as they will experience a shortfall between their SMI award and their monthly mortgage payments. Citizens Advice believes that this is inequitable.

The standard interest rate is also arbitrary in its discrimination between claimants. Whether claimants receive an SMI payment which covers

12. Ford, Wallace, Munro, Sprigings and Smith (University of Glasgow, June 2011). *An evaluation of the January 2009 and October 2010 arrangements for Support for Mortgage Interest: the role of lenders, money advice services*, Jobcentre Plus and policy stakeholders, p27-28.
13. Ibid. p29.
14. Citizens Advice, Advice UK and Shelter (2009) *Turning the tide? Evidence from the free advice sector on mortgage and secured loan possession actions in England in July 2009.*

their entire monthly mortgage payment or experience a shortfall is based solely on their contractual interest rate and bears no relation to the size of their mortgage or the amount they actually pay each month. As a result a claimant with a high interest rate but a low monthly mortgage payment may experience a shortfall while a claimant with a lower interest rate but a higher monthly mortgage payment may receive an SMI payment which covers their entire monthly mortgage obligation, or even an award in excess of their mortgage obligation.

For example:

- Person A has a £200,000 mortgage, an interest rate of 3.63 per cent and therefore a contractual monthly interest payment of £605.
- Person B has a £100,000 mortgage, an interest rate of 6 per cent and therefore a contractual monthly interest payment of £500.
- Based on a standard interest rate of 3.63 per cent Person B will receive an SMI award of £302.50 per month, leaving a shortfall of £197.50 per month.
- Despite having a higher contractual monthly interest payment than Person B, Person A will have their entire contractual monthly interest payment of £605 met because their interest rate happens to be the same as the standard interest rate.

Turning the tide? also found that the disadvantage experienced by claimants with an above average interest rate is further compounded by the fact that borrowers with sub-prime mortgages were disproportionately represented amongst the possession cases analysed (21 per cent) when compared with the market share of this type of lender (2.3 per cent).[15]

A CAB in the South West of England reported the case of a single man with mental health problems who was in receipt of ESA and SMI. The client had a fixed rate, interest only mortgage with an interest rate of seven per cent. Before the change to the standard interest rate he was able to manage to make up the small shortfall between the amount of SMI he received and his monthly mortgage payments. After the standard interest rate was reduced to 3.63 per cent, however, SMI only paid just over half of his monthly payment and he could no longer afford to meet the shortfall from his benefit income. The client was unable to obtain a mortgage at a lower interest rate because of his circumstances and he feared that his home would be repossessed. This was having an impact on his mental health.

Lenders are not absorbing the difference and are taking possession action

When the Government announced the change in the way that the standard interest rate was to be calculated, the Minister for Welfare, Lord Freud, stated that the Government expected mortgage providers to soften the impact of the changes by averaging out the rates charged to borrowers.[16] The Minister also hinted that the Government would consider legislating if the mortgage providers failed to do this. The Department of Work and Pensions impact assessment for the change reasserted this expectation, stating that ‘based on conversations with the CML we would expect lenders to demonstrate forbearance in the vast majority of these cases.’[17]

Of the 456 BEFs analysed, 202 contained some information on what, if any, action had been taken by the lender following the change to the standard interest rate. In 33 per cent of these cases the lender had initiated possession action, such as applying to the court for a possession order or a notice of eviction, or were threatening to do so if the client’s financial situation did not improve. This was a 19 per cent increase when compared to the number of cases in which the lender had initiated, or was threatening to

15. Citizens Advice, Advice UK and Shelter (2009) *Turning the tide? Evidence from the free advice sector on mortgage and secured loan possession actions in England in July 2009.*
16. Financial Times online edition. (Published 30 September 2010). *Lenders shun mortgage plan for jobless.*
17. Department for Work and Pensions (August 2010). *Equality Impact Assessment Support for Mortgage Interest.*

initiate, possession action before the change to the standard interest rate.

Although drawn from a relatively small sample, these findings suggest that mortgage providers are not lowering the contractual monthly payments of borrowers in line with the reduction in SMI payments as the Government hoped. Rather, they are passing the shortfall on to their customers and expecting them to make up the difference from their already limited income, with disastrous results. This is in direct contradiction to Lord Freud's stated expectation when the reduction in SMI was announced.

Some of those in receipt of SMI, such as the elderly and those with disabilities, may reasonably be expected to continue to receive the benefit for a significant length of time, and perhaps indefinitely. Consequently, it is perhaps unreasonable to expect mortgage providers to accept and absorb shortfalls in payment in the longer term. In addition, if mortgage providers were obliged to forebear indefinitely in cases where SMI was in payment, these providers may feel less willing and able to forebear more widely across the market.

A CAB in the North West of England reported the case of a man who was single parent looking after his disabled son. The client lived in a mortgaged home with contractual payments of £560 per month. Prior to October 2010 the client received £433 per month in SMI payments but this had reduced by £173 per month following the reduction of the standard interest rate. The client was unable to afford to make up the shortfall and had accrued arrears of approximately £1,000. As a result his mortgage provider had commenced possession proceedings, causing the client distress and financial hardship and putting the client and his son at risk of losing their home.

A CAB in the East of England saw a man who was disabled and cared for full-time by his partner. The client had arrears and had agreed with his mortgage lender to pay an additional amount per month towards repaying them. Since the standard interest rate for SMI was reduced the client had a monthly shortfall and could not meet his payments. As a result the client had received notice of possession from the lender. The client had post-traumatic stress disorder and this issue was having a negative effect on his health as well as causing significant financial hardship.

A CAB in London reported the case of a retired woman who suffered from depression and was in receipt of state pension and pension credit. She lived in a mortgaged property on which the payments were £950 per month and was in receipt of SMI. Originally her SMI payments were £467 per month but after the reduction in the standard interest rate this fell to £280 per month, leaving the client with a shortfall of £680. Based on her income and expenditure, there was no way that she could afford this. For the first few months she was able to make up the difference by borrowing from her son, however he soon lost his job and was no longer able to support her. As a result her mortgage fell into arrears, she fell behind in repayments to other creditors, and she was struggling to make ends meet. The mortgage provider was threatening to commence legal possession proceedings and the client, who had been living in her home for 18 years, was terrified that she would be made homeless. This was having a significant impact on her already fragile mental health.

The change to the standard interest rate has hit the most vulnerable hard

Our evidence suggests that the reduction in the standard interest rate has hit the most vulnerable particularly hard. Eighty three per cent of the BEFs analysed concerned clients who would be considered to be in priority need should they require re-housing by virtue of their age, having a disability, and/or having dependent children.

- Thirteen per cent of the BEFs analysed concerned clients who were aged 65 or over, compared to four per cent of all CAB clients seeking advice on mortgage arrears.
- Over half of the clients in the BEFs analysed (54 per cent) were recorded as having a long term health problem or a disability, compared to 25 per cent of all CAB clients seeking advice on mortgage arrears.
- Where this information was known, 37 per cent had dependent children, compared to 47 per cent of all CAB clients seeking advice on mortgage arrears.

A number of clients, 13 per cent, reported that they had cut back on expenditure on essential bills and outgoings, such as electricity and food, in order make up the shortfall in their mortgage payments. For example:

A CAB in Wales reported the case of a man in receipt of ESA. He had a mortgage with a contractual monthly interest payment of £484 plus an additional £40 per month to pay towards his arrears, totalling £524. Prior to October 2010, he had received £686 per calendar month, but this was reduced to £448 per calendar month, leaving him with a shortfall of £76 per month. The client was already on a tight budget and often could not afford to heat his home. After the change he was unable to afford a television licence and often sat at home in the darkness and the cold because he had no money. The adviser noted that the client had contemplated suicide in the past and was concerned that this might 'send him over the edge'.

A CAB in the East of England saw a man who was in declining health and had been in receipt of ESA for year. He lived alone in a housing association flat on which he had a £30,000 mortgage. Following the change to the SMI standard interest rate, his payments had reduced by £60 a month. He had been paying £50 per month to rent a television, washing machine, cooker and fridge/freezer but had to return them to cover the mortgage shortfall. He applied for a community care grant to cover the cost of buying second-hand white goods from a local charity but was turned down.

Disability living allowance (DLA) is a non-means-tested benefit paid to those with care and/or mobility needs as a result of a mental or physical disability. The benefit consists of two components, a care component for help with personal care needs and a mobility component for help with walking difficulties. DLA is designed to be used to help mitigate the extra costs associated with having a disability, such as additional heating or making adaptations to the home, and claimants must meet a number of strict criteria in order to receive it.

We have received evidence that some clients with disabilities and long term health problems have found themselves in a situation where they are forced to choose between using their DLA payments for the purpose for which they were intended or making up the shortfall between their SMI payments and their monthly mortgage payments. For example:

A CAB in London reported the case of client in receipt of SMI and a disability benefit. Prior to October 2010 the client had a shortfall between his SMI payments and his contractual monthly interest payment of £48 which he just about managed to cover by budgeting well. Since the standard interest rate used to calculate SMI was reduced the shortfall had increased to £143 per month. The client could not afford this increase and was having to use his disability benefit to make up the shortfall. This left him unable to pay for a carer or use the money to increase his mobility.

A CAB in Yorkshire and the Humber saw a woman who was disabled and unable to work after suffering a brain haemorrhage. She was in receipt of a disability benefit and received a total of £550 in benefits per month. Due to the reduction in SMI in October 2010 the client had a shortfall of £105 to pay towards her mortgage. She had a very tight budget and could not afford to meet her mortgage payments without using her disability benefit payments, seriously reducing the amount of money she could afford to spend on maintaining her independence. The adviser noted that the Government's aim of saving money meant that the most vulnerable were being pushed into hardship and that money the Government gives the disabled to help them on the one hand is taken out of their pocket by a change of policy with the other.

Alongside the severe financial repercussions of the decision to reduce the standard interest rate, three per cent of the clients described in our evidence about SMI between 2010 and 2011 reported that the challenges caused by the change had had an impact on their physical health. Twenty nine per cent reported an impact on their mental health. For example:

A CAB in the South East reported the case of a mother living with her son and two daughters in a property owned jointly with her abusive ex-husband. The client was dependent on income support and incapacity benefit as her only income and was not informed when her SMI payment was reduced from £450 to £269 per month, causing her to fall into mortgage arrears for the first time. She was unable to afford to make up the shortfall between her SMI award and her contractual mortgage payment, a situation made worse by the £200 charge imposed by the mortgage lender for falling into arrears. She was no longer able to afford to pay all her bills regularly and on time and suddenly finding herself in debt had caused her considerable distress and anxiety, making it difficult for her to see any solution. Her daughter said that she had tried to commit suicide in the week before she turned to the CAB.

It is clear, therefore, that the decision to reduce the amount of SMI received by claimants by changing the way in which the standard interest was calculated has had a hugely detrimental impact on those who rely on the benefit to maintain their contractual monthly mortgage payments and remain in their homes.

Conclusions and recommendations

The evidence received by Citizens Advice and set out within this report clearly demonstrates that the current system for calculating the amount of support available to SMI claimants has failed to adequately meet the needs of claimants for the following reasons:

- Given the range of different interest rates in the mortgage market, using a standard interest rate, particularly one set at the national average mortgage interest rate, creates a shortfall between the amount of support received and monthly mortgage commitments for around 50 per cent of claimants.
- Contrary to the Minister's stated expectation and assurances at the time of the decision to reduce the standard interest rate, CAB evidence shows that mortgage lenders have not always absorbed the shortfall and have been unwilling to forebear in cases where a shortfall exists.
- The reduction in the standard interest rate and the payment shortfalls this has caused has hit the most vulnerable very hard.

The decision to move away from paying SMI at claimants' actual interest rates and introduce a standard interest rate in 1995 was designed for administrative simplicity rather than reducing welfare expenditure and reducing the deficit. While the current system may be administratively simple, it is not providing adequate support to a sizable proportion of recipients. We also believe it to be unfair. The Government should therefore alter the mechanism for calculating SMI so that the amount claimants receive reflects their actual interest rate while minimising the administrative costs.

The impact assessment for the proposals contained in the Government's current SMI consultation also suggests that the standard interest rate does not provide value for money. One of the primary justifications given for the decision to reduce the standard interest rate in October 2010 was the fact that many recipients were receiving SMI awards in excess of their monthly mortgage interest payments. The impact assessment, however, shows that 47 per cent of recipients, 97,300 people, continue to receive SMI payments in excess of their monthly mortgage interest payments under the reduced standard interest rate.[18] CML analysis quoted in the impact assessment, also suggests that an SMI regime which was identical to the current system in every way, but paid at the claimants' actual interest rate, would save the DWP around £25 million per year in SMI payments.[19]

In addition, if the way in which the level of SMI received by recipients is calculated continues to result in a shortfall for a significant proportion of recipients, the number of repossessions amongst those in receipt of SMI is likely to increase. The DWP acknowledges that keeping people in their homes through SMI reduces the costs that fall on wider society as well as preventing the private costs to the individual of losing their home.[20] Citizens Advice agrees with this. For instance, the Department for Communities and Local Government have estimated that 'the average quantifiable cost to the exchequer of a repossession of a vulnerable household is £16,000'.[21] Other estimates are higher.

We would also highlight additional ongoing costs resulting from SMI recipients losing their homes. For instance, a proportion of SMI claimants who have their homes repossessed are likely to be eligible for housing benefit either straight away or, in the case of those with equity in their homes, in the future. In May 2011 the average weekly housing benefit award was £87.46 per week, compared to an average SMI award of £29.84 per week.[22] The DWP acknowledges this, while pointing to current low mortgage interest rates lowering the average SMI payment. However we estimate that the average SMI payment would still be lower than the average housing benefit payment if the average mortgage market rate had reached a series peak of 7.41 per cent – £60.91 per week compared to £87.46 housing benefit.

The Government's options for reforming the standard interest rate

The Government's current consultation on SMI presents three possible approaches for the calculation of SMI awards in the future:

1. Retain the current system.

As outlined throughout this report, the current system has failed to provide adequate support to a significant proportion of SMI claimants causing considerable hardship, and the threat of losing their home, to some of the most vulnerable in society.

Citizens Advice strongly disagrees with the proposal to retain the current system.

2. Introduce a system of two or three standard interest rates linked to average rates of particular mortgage products.

While three standard interest rates, reflecting the average rates of different mortgage products, would more accurately reflect the actual interest rates of some claimants, claimants with interest rates above the average rate for their mortgage product would be penalised and continue to experience a shortfall.

Therefore, while marginally preferable to a single standard interest rate, Citizens Advice believes that this system would still leave claimants vulnerable to hardship or mortgage arrears due to shortfalls.

18. Department for Work and Pensions (December 2011). *Impact assessment: Support for mortgage Interest Public Call for Evidence*
19. Department for Work and Pensions (December 2011). *Impact assessment: Support for mortgage Interest Public Call for Evidence*
20. Department for Work and Pensions (December 2011). *Support for Mortgage Interest: Informal call for evidence*
21. Department for Communities and Local Government (2008). *Homeowners Support Package. Impact Assessments.*
22. Department for Work and Pensions (December 2011). *Support for Mortgage Interest: Informal call for evidence.*

3. Introduce a system of paying claimants' contractual interest rates, subject to a cap, where mortgage lenders commit to notifying the Department of changes in rates within set timescales.

Citizens Advice strongly supports a system where SMI is based on the amount claimants actually pay. However, we do not believe that this should be subject to a cap. Mortgage market rates are not subject to caps, therefore the amount of support available to home owners should not be capped. Such a cap would also be inequitable between borrowers as those with higher than average interest rates, who are already disadvantaged by virtue of paying above average for their mortgage, would then be penalised again. Furthermore there are already caps on the amount of capital, currently set at £200,000, on which SMI can be claimed. This should be sufficient without the introduction of additional caps.

Therefore Citizens Advice recommends that SMI is paid at the contractual interest rate and that no additional cap on this is needed.

How SMI can be administered more cost effectively

There is also an opportunity here to think about how SMI can be administered in a more efficient way.

We envisage a mechanism whereby:

- **the Government calculates the eligible capital on which the home owner can claim SMI**
- **the mortgage provider then calculates how much SMI the individual can claim based on their actual mortgage interest rate**
- **the mortgage provider block bills the Government each month for the total amount of support their customers are eligible for.**

Under this system all SMI claimants will receive the full level of support they need to stay in their home while the administrative cost to the Government is kept to a minimum. This would deliver on objectives to minimise the risk of repossessions and Government could more realistically expect lender forbearance.

We believe that the Government should investigate this proposal which we believe could provide a fairer and more efficient way of delivering support to low income home owners.

We acknowledge, however, that this system does not necessarily fit comfortably with the Government's plans to assimilate SMI into the new universal credit, under which the mortgage interest direct scheme would be replaced by payments to claimants. These payments would then need to be passed on to the mortgage lender.

While we appreciate that the Government is seeking to make the experiences of those in receipt of out-of-work benefits reflect those of people in work, we are concerned that this will make any mechanism for paying claimants less efficient and may also have an impact on mortgage providers' willingness to forebear.

With competing demands and limited resources, budgeting on a benefit income can be extremely challenging. The Council of Mortgage Lenders and the Building Societies Association have both voiced concern that a move away from mortgage interest direct will result in some of the payments intended to help claimants meet their mortgage costs being diverted to other areas of expenditure.[23]

This is a concern shared by Citizens Advice. When faced with urgent bills that need to be paid and intense pressure from all creditors to meet monthly payments, SMI claimants may well be tempted to pay the most urgent bill or the creditor shouting the loudest first, therefore putting themselves at risk of mortgage arrears and possession proceedings. **In our view, therefore, the mortgage interest direct scheme should be retained in order to ensure that lenders continue to forebear in cases where SMI is in payment and the scheme remains effective.**

23. Council of Mortgage Lenders (December 2011). http://www.cml.org.uk/cml/media/press/3112; Building Societies Association (December 2011). http://www.bsa.org.uk/feature/DWP_SMI.htm

Written and researched by Anne Pardoe

Citizens Advice
Myddelton House
115-123 Pentonville Road
London N1 9LZ

Telephone: 020 7833 2181

www.citizensadvice.org.uk
www.adviceguide.org.uk

Citizens Advice is an operating name of
The National Association of Citizens Advice Bureaux.

Registered charity number 279057

February 2012